RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

PO Box 1759, La Jolla, California 92038 — SINCE 1958 — 17 Letters Per Year - $250 Annually

LETTER 1329

January 2, 2002

Dec. 14,DJIA 9811.15; PTI 5330; AD Ratio-1.47
Dec. 21,DJIA 10035.34; PTI 5341; AD Ratio-1.47
Dec. 28,DJIA 10136.99; PTI 5357; AD Ratio -.41
Dow Yield: 1.79% Dow p/e: 27.99
Gold 50 day MA: 277.50

WHAT IS IT? A long-term view of the price action often provides a different perspective. Below is a monthly chart of the widely-followed S&P 500 Composite. Study the rally off the September 21 low. Does this look like "a new bull market"? Or does it look like the right shoulder of a huge "head-and-shoulders top" pattern?

My own inclination is to call what we see here the formation of a huge top. Of course, if the S&P climbs to a new high we'll go back and re-classify the situation as either a continuation of the old bull market or a new mini-bull market.

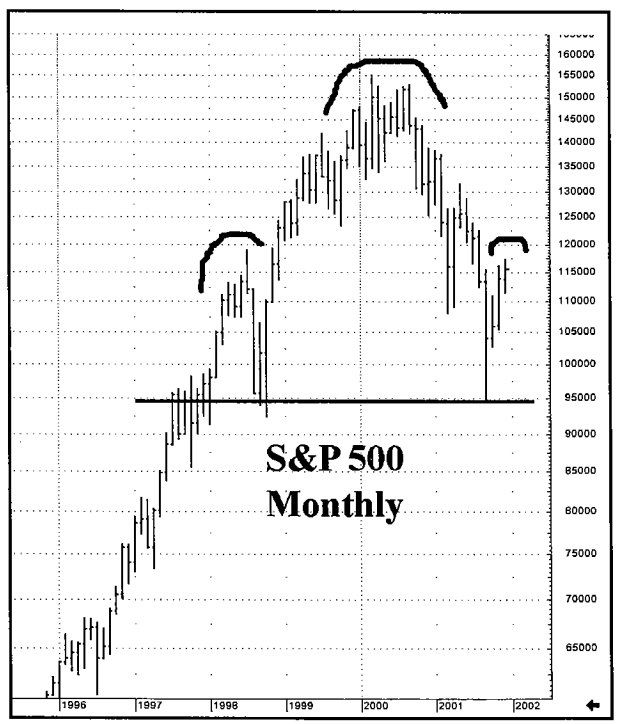
THE PICTURE : The investor today has three main enemies in his effort to create assets. The first is **ignorance**. This is just a lack of knowledge about what it takes to build assets. On the main web-site of Dow Theory Letters I include a number of articles, each one dedicated to showing investors how to build assets and how to avoid punishing mistakes. So the first enemy of investors is their own ignorance. But that can be corrected – through study and perseverance.

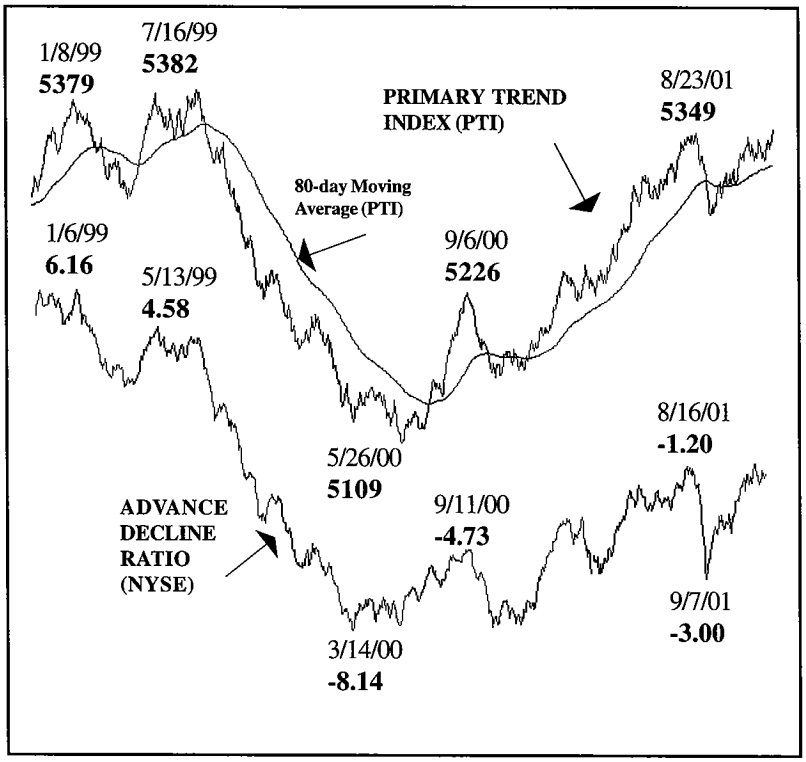
The second enemy of those who wish to build assets is **taxes**. There are many ways of avoiding taxes, the easiest and most accessible is the municipal bond. A second way is via long-term capital gains, which cuts taxes down to around 20%, rather than keeping taxes at the same rate as your regular income.

Another way of avoiding taxes is to use one of a variety of pension plans or annuities. This amounts to deferring taxes rather than avoiding them, but deferring is better than nothing.

The investor's third enemy in building assets is **inflation**. Another way of putting this is that all investors are in a battle to protect themselves from the Fed's systematic destruction of the purchasing power of the dollar.

For example, in 1945 I left the Army Air Corps with a $10,000 GI life insurance policy. Believe it or not, that was real money in 1945. It was retirement kind of money. I felt good about that $10,000. Today my GI policy (which I still have) is simply a testament to the predations of the Federal Reserve. Their systematic policy of inflation has run my insurance policy into the ground, making it almost a joke.





So how in the world can investors build assets? My formula is this – figure out what you need to live on. Then buy a relatively safe investment, an investment that throws off a steady stream of dividends or interest. And with that money, you diversify by buying other investments. But there's one rule – you MUST always buy securities that pay interest or dividends.

Of course, then you're in the compounding business. When you're in the compounding business you have one major ally – that ally is TIME. The longer the time you have to compound, the more successful you will be.

Unfortunately, most investors learn about compounding in their 40s or 50s or even 60s. By that stage in their investment life, they have lost a great deal of time. But better late than never. Obviously, the ideal time to start compounding is when you are young.

There's another rule in building assets. It's this – you must always spend less than your net income. If you are not doing that, you're building debt and living a fool's life. And obviously, if you're accumulating debt you can't compound. You can't build up assets if you can't continue to contribute to your compounding program.

What about taxes? You pay 'em. The way around taxes is municipal bonds, and it behooves all investors to learn the ins and outs of municipal bonds. One way of building assets is to start with a basic investment in municipal bonds, then use the tax-free interest to buy good dividend-paying common stocks.

All very good, you say, but what do you do in a primary bear market? My answer to this is that I personally would move out of common stocks during a bear market and simply continue to compound with tax-free municipal bonds. Then when the bear market ends, I would start using the bond income to buy common stocks.

In today's speculative, high risk market you hear a lot of pooh-poohing dividends. These people don't understand investing and asset building.

Would Warren Buffett ever buy a company that isn't throwing off cash? By the same token, would any seasoned investor buy a stock that isn't throwing off a steady stream of dividends?

A brilliant two paragraphs has just been written by one of the smartest men in this business, Peter Bernstein who writes Economics and Portfolio Strategy (he's also authored many classic books on investing). (www.peterlbernsteininc.com)

He writes, "The dividends analysis, on the other hand, confirms the persistence of irrational exuberance. How well do equity investors understand the game they are playing? The popular view today is to equate dividends with great-grandfather's rocking chair on the porch of the old homestead. We disagree. Today's dividend yields put equity investors totally at the mercy of one another – what John von Neumann characterized as 'combat and competition.' "

"When cash flow is a trickle, the investor cannot obtain cash, for any purpose, without finding a buyer for equity positions owned. The buyer may or may not be there when needed. The price the buyer is willing to pay may or may not provide the total return the investor originally expected. Investments without cash flows are risky, uncertain. In bond market talk, they have long durations, which means high volatility. Under even decent equity results, the prospective margin to be earned in bond interest over the next 25 years seems much too small to compensate for the higher level of risk in equity ownership.

"The arithmetic is beyond manipulation. Like it or not, dividend yields around 1.5% present a terrible obstacle to the kinds of returns investors claim to expect and to the kinds of returns they acknowledge they require. Traders may find entertainment in this environment. Investors who claim they are in the game 'for the long run' should take heed." (More on Bernstein's thinking in the Investment Position section).

I want to address another area in which there seems to be much puzzlement. And this is the area of both corporate and consumer spending. The general thinking is that the Fed just "creates the money" and corporations and consumers then spend it. Things don't work out exactly that way.

A subscriber, a retired banker, sent me an e-mail and I quote a few paragraphs –

"It is currently illegal for individuals privately to print or coin money, which is an exclusive privilege given to the state (Russell comment: The states or our Congress gave it to the Fed). However, the government is bound by the current rules of monetary creation, which is limited to the Federal Reserve having the ability to create new bank reserves through its open market operations. (The Fed also lends money through its discount window and sets the reserve requirements for the banks, although the open market operations are by far the most powerful money creation tool).

"Even though Alan Greenspan and the Fed have been feverishly pushing down the Fed's key interest rate, the wave of business investment that would allow the money multiplier effect to take place during a boom has not occurred during this latest bust. This is hardly surprising, given the economic uncertainty that businesses are currently facing.

"All of this presents a real problem to those who claim that a new wave of consumer spending will end this recession. Since new money enters the economy through the banking system, the only way we see cash infusions is through increased bank lending. The present economic climate, however, is not conducive to bank lending, which poses a real problem for those who believe that the only way to recovery is for consumers to spend as though helicopters were dropping vast sums of money across the country."

Russell Comment: The above is an excellent description of the current problem that the US government faces. The writer then offers a tongue-in-cheek method of getting cash directly to the public. His prescription – counterfeiting. Make counterfeiting legal so anybody and everybody could print their own money. Alan Bonkers Greenspan – are you listening?

NOTES & QUOTES : Coming up, an increasing use of "hybrid cars" or cars using both gas and electric motors. Honda has the Insight, price $21,600, which is CVT (for continuously variable transmission). The car achieves a MPG of 52 miles in the city, 45 on the highway. It's also a super-low emissions car. Toyota will also have its own hybrid.

Honda will be coming out with the Civic hybrid. This will be mostly aluminum, and it will be a five-passenger car. The talk is that this will be more of a "real car" than the two above. Would I buy a hybrid car? You bet I would, and my next car will almost surely be a hybrid.

* * * * *

Do you wonder about what it was like during World War II compared with the "war" today? Today, out of a population of some 281 million Americans, a little more than 1.4 million people are in the armed services, which is less than half of 1% of the population. By the close of WW II nearly 9% of the nation's 140 million people were in uniform or about 12 million. At that time Americans sacrificed far more than they are "sacrificing" today. Virtually every resource in the nation was called upon to provide food, arms and supplies for the War.

So far the Bush Administration has not asked its citizens to do much of anything but "buy, spend, buy, travel, buy stocks" and to generally support the "war on terrorism." As far as casualties, they are tiny compared with US losses during WW II. The US suffered about 300,000 casualties. Of course, the Russians suffered 1.5 million dead. In the British RAF of 125,000 flyers, 60,000 died either in combat or accidents.

* * * * *

"Why the World Loves to Hate America," is the headline of an article in the *Financial Times.* And the reasons – "The list of American realities that jar the sensibilities of citizens of other countries is long: women's rights, sexual permissiveness, drug use, gun ownership, the death penalty, intrusive marketing, fast food, tolerance for economic inequality, racism and high incarceration rates. Psychologically, anti Americanism is fueled by jealousy, resentment, ambivalence, and crushed expectations. The seductive allure of American capitalism, freedoms, products and culture often co-exist with ambivalence about them as being economically or politically unobtainable".

Russell Comment: If you see something that you want, but you know you can't have it, there's often an urge to destroy the object that tempts you. I've written before that men are frightened by women's sexual power. How to cope with it? Demean women, make them wear cover-up clothes, deny them the vote, deny them an education.

The rapid collapse of the sadistic Taliban has impressed the world. On the evidence of US military campaigns of the last decade in Iraq, Afghanistan, and the Baltics the gap between US capabilities and the capabilities of any other nation looms dramatic. The sheer amount of US spending on the military dwarfs the spending of any other nation. The US now accounts for 36% of all military spending around the world. The US spends more than the next nine nations in line on defense. Such domination has never been seen before, and according to Professor Paul Kennedy of Yale, US world military domination now surpasses that of Philip of Spain and the Roman Empire.

Taking note of this giant military machine is China. Military experts believe that China has exercised caution as it watches the US military in action in Afghanistan. China has been refurbishing its military, partly with Russian help.

Russell Comment: It's obviously absolutely essential that the US, China and Russia remain on friendly terms.

* * * * *

States are being squeezed by the worst budget crunch in a decade. As a result, states are scrambling to avoid raising taxes or cutting back on education. This is resulting in a rash of across-the-board cuts in states' budgets. State governors say they'll need over $4 billion in government aid.

According to a survey released a few weeks ago, 35 states face a total budget shortfall of more than $25 billion for this fiscal year, the worst performance since 1992.

All of these states will either have to cut spending or raise taxes. One thing is sure – state governments will not be a source of jobs. The governor's association's latest survey says that 43 states and the District of Columbia will report revenues below their forecasts. That will mean furloughing or laying off employees, delaying school construction and road repairs and lowering benefits for some Medicaid recipients. But the worries don't end there. As state legislatures reconvene in January, the big worry will be the fiscal 2002 budgets.

* * * * *

Once More for non-computer subscribers – Let's do you and me a favor. It costs me 34 cents to send the thrice-weekly Letter to you via "snail mail." Now here's where the joint-favor comes in. Yeah, I know you hate computers. But you don't need a computer. Go out and buy an i-PAQ from your local computer store or from Radio Shack or from Compaq, and with it you can get on the Internet with its fabulous entrance to the world of knowledge and news (and I'm serious about that), plus you can send e-mails to your friends and kids and buddies around the world – at no cost – free.

My 73-year old sister who used to shudder and turn white at the very word "computer" recently bought an i-PAQ and she loves it – she sits there three hours a day and absorbs info on everything from the latest disease to the weather in Hawaii.

But here's the real bargain (no kidding). With the i-PAQ you'll get Dow Theory Letters instantly when it's posted to our website. And you'll get six (count 'em) of my daily market comments each week, Monday through Saturday – one every day but Sunday.

As for me, I'll save the postage on the Letters, and I'll also save the cost of mailing and paper, and I'll be much happier knowing that ALL my subscribers are getting the "total package" that I offer each week. After all, how do you think I feel writing my little heart out every day and knowing that thousands of my subscribers are only getting the "regular" Letter once every three weeks. So c'mon, you old foggies, get into the 21st century with an i-PAQ or maybe even with a simple computer. You'll be doing both of us a favor. And you'll thank me, honest you will. If you want, you can order i-PAQ over the phone at 1-800-AT-COMPAQ.

* * * * *

In the US the population numbers are changing. Of the US population 24.5% are Catholics (up 10.6% since 1990), Baptists comprise 16.3% (down 0.4%), 6.8% are Christians of no denomination (up 75.8%), 6.8% are Methodists (down 0.2%), 4.6% are Lutherans (up 5.2%), 2.7% are Presbyterian (up 2.6%),and 1.4% are Jews (down a whopping 9.8%).

When I was a boy, 5% of the population was Jewish. It's now down to 1.4% and declining fast. Half of the Jewish population intermarries and their kids often become something other than Jews. In twenty years, if you want to be an active anti-semite you may have go to Europe or the Mideast. There won't be enough Jews in America for you to bother with.

* * * * *

They say being mayor of New York City is the second toughest job in the nation. Some think it's the toughest. Consider this – In New York every mayor since Fiorello La Guardia has left office either defeated or totally demoralized. Vincent Impelliteri, Abe Beame, Ed Koch and David Dinkins all lost bids for re-election. William O'Dwyer resigned in disgrace and Robert Wagner and John Lindsey lost the will even to run again.

Guiliani's reputation was saved by his heroic action after 9/11. Mike Bloomberg is now up at bat, and he's facing a huge City deficit. Will he be a hero or a bum? Personally, I like Bloomie (Mayor Mike) a lot, but he's got one rough job ahead of him (he'd better study up on La Guardia, the much-loved "Little Flower").

* * * * *

INVESTMENT POSITION: The bear remains in the box.

Here's a fascinating study from the brilliant pen of Peter Bernstein ("Economics and Portfolio Strategy" 575 Madison Ave., NYC 10022 price per year $1,675). The yield on the S&P is currently 1.3% while the long bond's yield is 5.6%. The growth of stock dividends over the last ten years is roughly 2.6%. Bernstein then asks this question – over the long term, say 25 years, how does compounding stock dividends compare with compounding bond interest? And here's his answer, using current rates of return and a time-span of 25 years.

"The equity investor will receive a total of $562 in dividends on one share of the S&P 500 over that time span of 25 years — or 49% of his original investment of $1158 ($1158 was the cost of one share of S&P).

"The bond investor, however, will book a total of $1,618 in coupon receipts on an investment of the same size and over the same time span. If you also figure in reinvestment of income, the gaping spread becomes even more awesome than it is already."

Russell Comment: This is a crucial and fundamental study. Let me add one further consideration. Instead of using the T-bond, if you use a top grade muni bond, the comparison would look even better, since you're paying taxes on the dividends from your stock purchase whereas you're compounding your muni interest free of taxes.

The above study shows the problem with buying stocks today, stocks that pay little or no dividends as compared with bonds that pay interest of 5.6% or preferably bonds that pay tax-free interest of say 5%.

All of the above points up the danger of buying stocks on the thesis that they "should" or "must" go up over the long term. At today's high valuations, there's no guarantee or even logic that says that stocks that are bought today should or must go up over the long term. Let me put it this way – if the stocks that you buy today don't go up, you're not getting paid for waiting (and God forbid if instead of advancing or standing still, stocks decline).

So on a compounding basis over the long-term, interest on bonds will far outperform dividends from stocks. And that's a consideration that every investor must face and deal with. Thus, those who buy stocks for the long term at these high valuations must depend totally on capital gains.

LATE NOTES: Despite the massive re-inflation efforts of Alan "gone bonkers" Greenspan, commercial and industrial loans are declining and have been declining since last January. Remember, in a credit nation you create money when you extend credit. When you borrow a thousand bucks from the bank, the bank deposits the money in your checking account. The bank then can lend a percentage of that deposit to another borrower. This process can end up with a six-fold multiplier if people continue to borrow.

Right now we're seeing a fierce battle between inflation (which the Fed is intent on generating) vs. the global forces of deflation. There's almost no pricing power in the US economy (except for housing, which can't be imported). But anything that can be manufactured is now subject to intense competition and price pressure. China alone could probably supply the entire world with what it needs in manufactured products (and China would undoubtedly love to do exactly that).

The powerful opposing forces of inflation and deflation promise to make 2002 a wild one, an "economic doozie." There, you heard it here first. Get ready for surprises, lots of them. Happy New Year!

NEXT MAILING JANUARY 24, 2002